LIBRARY
SUPREME COURT, U. S.

Supreme Court, U.S.
FILED
APR 24 1971
E. ROBERT SEAVER, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1628

NOVELART MANUFACTURING COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

STANLEY GOODMAN
GOODMAN & GOODMAN
1016 Fourth & Walnut Building
Cincinnati, Ohio 45202
Counsel for Petitioner

SOLICITOR GENERAL OF THE
UNITED STATES
Department of Justice
Washington, D. C. 20530

JOHNNIE M. WALTERS
Assistant Attorney General
Tax Division
Department of Justice
Washington, D. C. 20530

K. MARTIN WORTHY
Chief Counsel, I. R. S.
Washington, D. C. 20224
Counsel for Respondent

E. L. MENDENHALL, INC., 926 Cherry Street, Kansas City, Mo. 64106, 421-3030

INDEX

Opinions Below 2

Jurisdiction 2

Questions Presented 2

Constitutional Provision and Statutes Involved 4

Statement of the Case 10

Reasons for Granting This Writ 15

Conclusion 38

Appendix A—

Opinion of United States Court of Appeals, Sixth Circuit, November 27, 1970 ..... A1

Memorandum, Findings of Fact, and Opinion of Tax Court, August 11, 1969 ..... A4

Decision, Tax Court, September 18, 1969 ..... A39

Table of Cases

Adolph Coors Co., T. C. Memo 1968-256 22

Alma Piston Co., 22 T. C. M. 948, 1963 P-H T. C. Memo ¶ 63,195 13

Apollo Industries, Inc. v. *Commissioner*, 358 F.2d 867 .. 16

Battlestein Investment Co. v. *United States*, 69-1 USTC ¶ 9219, 23 AFTR2d 69-784 (S.D. Tex. 1969) 21

Berizzi Brothers Co., 16 BTA 1307 31

Brown Agency, Inc., 21 BTA 1111 31

Chism Ice Cream Co., 322 F.2d 956 31

C.I.R. v. *The Shaw-Walker Co.*, 393 U.S. 478 (1969) 21

Crawford County Printing and Publishing Co., 17 T. C. 1404 ..... 15, 16

Dixie Inc. v. *C.I.R.*, 277 F.2d 526 (2nd Cir. 1960) 22

Duke Laboratories, Inc. v. *United States*, 337 F.2d 280 (2nd Cir. 1964) 25

Electric Regulator Corporation v. *C.I.R.*, 336 F.2d 339 ..... 20, 24

Emeloid Co. v. *Commissioner of Internal Revenue*, 189 F.2d 230 27

Faber Cement Block Co., 50 T. C. 31 (1968), *acq.* 1968-43 I.R.B. 6 ..... 17, 22

General Smelting Co., 4 T. C. 313 27

Healy and Smith v. *Commissioner*, 345 U.S. 278 36

Helvering v. *National Grocery Co.*, 304 U.S. 284 35

Helvering v. *Northwest Steel Rolling Mills*, 311 U.S. 46 34

John P. Scripps Newspapers, 44 T. C. 453 ..... 24, 25, 35

Mead's Bakery, Inc. v. *C.I.R.*, 364 F.2d 101 14

Mohawk Paper Mills, Inc. v. *U. S.*, 18 AFTR2d 6111 20

Montgomery Co., 54 T. C. 986 25

Motor Fuel Carriers, Inc. v. *U. S.*, 420 F.2d 702 (1970) .. 25

Nemours Corporation, 38 T. C. 585 (1962) *aff'd per curiam* 325 F.2d 559 (3rd Cir. 1963) 22

Peerless Pacific Co., 10 BTA 103 31

Peerless Patterns Co., 29 BTA 690 31

Rhombar Co. v. *Commissioner*, 47 T. C. 75, *affirmed*, 386 F.2d 510 17

Shaw-Walker Co. v. *C.I.R.*, 390 F.2d 205 14

Smoot Sand & Gravel Corporation v. *Commissioner*, 274 F.2d 495 35

Ted Bates & Co., 24 CCH TCM 1346 (1965) 25

The Dahlem Foundation, Inc. v. *United States*, 69-1 USTC ¶ 9129, 22 AFTR2d 5962 (9th Cir. 1968) 23

United States v. *Donruss Co.*, 393 U.S. 297 (1969) 21, 25

Whitney Chain & Mfg. Co., 3 T. C. 1109 (1944), *aff'd per curiam* 149 F.2d 936 (2nd Cir. 1945) 22

Wilcox Investment Co., 3 T. C. 458 31

CONSTITUTIONAL PROVISIONS AND STATUTES

Constitution of the United States—

Fifth Amendment 35
Sixteenth Amendment 4, 34, 35

Internal Revenue Code—

Section 264(a)(1) 4, 29
Section 531 ..... 4, 27, 32, 38
Section 532(b)(1) 4, 28
Section 533(b) 5, 28
Section 534(a), (b), (c) 5
Section 535 ..... 6, 32, 38
Section 537 22
Section 6501(a) 9, 25
Section 6601(f)(3) 9, 25
Revenue Act 1936, §§14, 26(c)(1) 34

TEXT BOOKS

Prentice-Hall—

Par. 16,751 29
Par. 16,765 30
Par. 21,332 28

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. .....

NOVELART MANUFACTURING COMPANY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Novelart Manufacturing Company, the Petitioner herein, prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit entered in the above entitled case on November 27, 1970; Petition for Rehearing denied January 25, 1971.

OPINIONS BELOW

The Opinion of the Circuit Court of Appeals for the Sixth Circuit is reported in 434 F.2d 1011 and 26 AFTR2d 70-5837 and is printed in Appendix A hereto, infra, Page A1. The Memorandum, Findings of Fact, and Opinion of the Tax Court of the United States are reported in 52 T.C. No. 83 and are printed in Appendix A hereto, infra, Page A4.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 27, 1970. Rehearing was denied on January 25, 1971. The jurisdiction of the Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

(1) Where a corporation has a need for additional plant space to carry out the existing business, and the Board of Directors instructs its President to obtain cost estimates in order that a decision could be made as to whether a new plant should be built or an existing plant expanded; where the evidence shows that approximately six months after the close of the year ended June 30, 1961, the corporation acquired a plant costing $532,000.00; and where the Tax Court finds and concludes that at the end of the taxable year ended June 30, 1961, one of the reasonably anticipated needs of the business was additional plant space to cost approximately $532,000.00, and this was also the situation at the end of the taxable year ended June 30, 1962; is it not clear error on the part of the Tax Court to hold that with a need for $532,000.00 it was an unreasonable accumulation to fail to distribute at the year ended June 30, 1961, the amount of $39,034.73 and at the year

ended June 30, 1962, the amount of $44,116.98 and at the year ended June 30, 1963, the amount of $22,444.41?

(2) Where the Tax Court finds that the Petitioner had reasonable needs, including anticipated needs in the amount of $782,000.00, during the taxable years involved herein, but that at the beginning of the taxable years Petitioner had accumulated earnings of approximately 5 million dollars, of which approximately 2-1/2 million dollars was in cash and securities, (a) may the Tax Court find that the retained earnings in the three taxable years, for a total of $106,000.00, are subject to the penalty because they were not distributed? (b) may interest be imposed on such penalty? and (c) is not such a finding by the Tax Court really the imposition of the tax on accumulations in prior years barred by the Statute of Limitations?

(3) Where the Petitioner, in a three-year period, retained earnings of $106,000.00 and paid on a group insurance plan on its employees a premium of $68,000.00, should such premium be allowed before a penalty is imposed for unreasonable accumulation?

(4) Where a corporation in a three-year period has income subject to accumulated earnings tax amounting to $106,000.00, and during said period expends $782,000.00 for plant improvements, is it not in violation of Amendment XVI to the United States Constitution to impose the accumulated earnings tax on the undistributed $106,000.00 because from prior years' accumulations the corporation had surplus funds of $782,000.00, and thus you could not consider the $106,000.00 as part of the $782,000.00 actually expended?

CONSTITUTIONAL PROVISION AND STATUTES INVOLVED

U. S. Constitution, Sixteenth Amendment

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration.

I. R. C., §264(a)(1)

(a) General Rule.— No deduction shall be allowed for—

(1) Premiums paid on any life insurance policy covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

I. R. C., §531

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

I. R. C.. §532(b)(1)

(b) Exceptions.—The accumulated earnings tax imposed by section 531 shall not apply to—

(1) a personal holding company (as defined in section 542).

I. R. C., §533(b)

(b) Holding or Investment Company.—The fact that any corporation is a mere holding or investment company shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders.

I. R. C., §534(a), (b), (c)

(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a) the Secretary or his delegate may send by certified mail or registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (e) (2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day.

(c) Statement by Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notifica-

tion described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

I. R. C., §535

(a) Definition.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

(b) Adjustments to Taxable Income.—For purposes of subsection (a) taxable income shall be adjusted as follows:

(1) Taxes.—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits, and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 275(a)(4)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(1)(C) for the taxable year, but not including the accumulated earnings tax imposed by section 531, the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law.

(2) Charitable contributions.—The deduction for charitable contributions provided under section 170 shall be allowed without regard to section 170(b)(2).

(3) Special deductions disallowed.—The special deductions for corporations provided in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) Net operating loss.—The net operating loss deduction provided in section 172 shall not be allowed.

(5) Capital losses.—There shall be allowed as deductions losses from sales or exchanges of capital assets during the taxable year which are disallowed as deductions under section 1211(a).

(6) Long-term capital gains.—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined without regard to the capital loss carryback or carryover provided in section 1212) minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including in taxable income the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year (determined with regard to the capital loss carryback and carryover provided in section 1212).

(7) Capital loss.—No allowance shall be made for the capital loss carryback or carryover provided in section 1212.

(8) Bank affiliates.—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(9) Distributions of divested stock.—There shall be allowed as a deduction the amount of any dividend

distribution received of divested stock (as defined in subsection (e) of section 1111), minus the taxes imposed by this subtitle attributable to such receipt, but only if the stock with respect to which the distribution is made was owned by the distributee on September 6, 1961, or was owned by the distributee for at least 2 years prior to the date on which the antitrust order (as defined in subsection (d) of section 1111) was entered.

(10) Special adjustment on disposition of antitrust stock received as a dividend.—If—

(A) a corporation received antitrust stock (as defined in section 301(f)) in a distribution to which section 301 applied,

(B) the amount of the distribution determined under section 301 (f) (2) exceeded the basis of the stock determined under section 301 (f) (3), and

(C) paragraph (9) did not apply in respect of such distribution,

then proper adjustment shall be made, under regulations prescribed by the Secretary or his delegate, if such stock (or other property the basis of which is determined by reference to the basis of such stock) is sold or exchanged.

(c) Accumulated Earnings Credit.—

(1) General rule.—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b) (6). For purposes of this paragraph, the amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

(2) Minimum credit.—The credit allowable under paragraph (1) shall in no case be less than the amount by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(3) Holding and investment companies.—In the case of a corporation which is a mere holding or investment company, the accumulated earnings credit is the amount (if any) by which $100,000 exceeds the accumulated earnings and profits of the corporation at the close of the preceding taxable year.

(4) Accumulated earnings and profits.—For purposes of paragraphs (2) and (3), the accumulated earnings and profits at the close of the preceding taxable year shall be reduced by the dividends which under section 563(a) (relating to dividends paid after the close of the taxable year) are considered as paid during such taxable year.

I. R. C., §6501(a)

(a) General Rule.—Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

I. R. C., §6601(f)(3)

(f) Applicable Rules.—Except as otherwise provided in this title—

* * *

(3) Interest on penalties, additional amounts, or additions to the tax.—Interest shall be imposed under subsection (a) in respect of any assessable penalty, additional amount, or addition to the tax only if such assessable penalty, additional amount, or addition to the tax is not paid within 10 days from the date of notice and demand therefor, and in such case interest shall be imposed only for the period from the date of the notice and demand to the date of payment.

STATEMENT OF THE CASE

Petitioner was formed in Ohio in 1905 under the name of Progress Lithographing Company. For a period of fifty-five years petitioner carried on the business of a general lithographing enterprise conducted in various plants, including one in Amberley Village, Ohio, and one in Lebanon, Ohio.

In 1958 petitioner involved itself in a plan of research and development in connection with applying lithography to the corrugated box business. This was done with the purpose in mind of developing a new industry. Other competing and non-competing companies that engaged in the same process and development expended millions of dollars in pursuance of such plan.

As of January 1, 1960, the corporate business was rearranged by forming a subsidiary under its own name of Progress Lithographing Company in Ohio and changing its name to Novelart Manufacturing Company through a merger with and resulting in a Delaware corporation.

The obvious plan was twofold in that it would permit employee participation in the Progress plant through setting aside part of the Common and Preferred Stock for the employees' pension plan and, second, to permit the petitioner, primarily through its President, Mr. Charles H.

Klein, to devote its monies and Mr. Klein's energy and ability towards the pursuance of the research and development in the corrugated box field in order to produce business for this plant as well as the searching out and acquisition of other plants.

In Petitioner's Statement of grounds on which it relied to establish that earnings and profits had not been accumulated beyond the reasonable needs of the business, it was set forth, and these things were sustained by the testimony of the witness Klein, that in 1958 a test was conducted on behalf of petitioner to obtain reactions from manufacturers, advertising agencies, and design specialists to a new lithographed, corrugated, cardboard container which petitioner had designed. Petitioner was advised by the report from A. C. Nielsen Company that the results of such test indicated that petitioner's process known as "Pre-Lith" for preprinting corrugated, cardboard boxes had received very high praise from all respondents and indicated a clear commercial acceptance for such products. Petitioner pursued its research and development, obtained national recognition in trade publications, and in the process met with some experiences which required a complete change of the methods and approaches. The record indicated that after the changes were made, patents were applied for, but that under the changed conditions the business produced was substantial.

The new methods and developments were put into use; and when petitioner became satisfied of their commercial acceptance, on May 20, 1963, which is during the last of the three years involved herein, Application No. 281600 was filed with the United States Patent Office for a patent on "Lithographed-Corrugated". Patent No. 3,306,805 was granted by the Patent Office on February 28, 1967. Applications for additional patents were ap-

plied for and are still pending. Applications were made in a number of foreign countries, and some have been granted.

The patent issued covers "apparatus for making printed corrugated paper board" and is described as relating to printed corrugated paper board; and more particularly the invention is directed to apparatus for manufacturing corrugated paper board in which one facing sheet is formed from a plurality of separate printed sheets.

Petitioner's testimony of its President, Charles H. Klein, indicated that the witness had engaged for forty years in the business of lithography, paper products, and the converting of paper. Petitioner's business, in the operation of its plants until January 1, 1960, consisted of commercial lithography, production of labels, advertising materials, and any other printing on paper by lithography.

In 1958 Mr. Klein decided on developing the corrugated box and container business, and the owner of a substantial number of shares of stock, Mr. Miller, disagreed with the plan, resulting in Mr. Klein purchasing his stock and becoming the sole owner.

The development of the business is fully explained by Mr. Klein.

The testimony established that petitioner is still directly engaged in business in that it has continued the development of the new processes for obtaining business, and the manufacturing was being done by Progress Lithographing Company. The record establishes that the petitioner acquired a plant and machinery with the object in mind of manufacturing part of the process and permitting Progress to do part of it. During the years in question, Mr. Klein was an officer of petitioner, but held no office in Progress Lithographing Company. The pe-

titioner, during the taxable years, in addition to research and development, was the owner of plants, including production machinery. Some of this machinery went into the Mitchell Avenue plant. The plant is operated by Litho Carton & Container.

The witness further testified that petitioner recently acquired a plant in North Vernon, Indiana, which is operated directly by petitioner. This plant represents an investment of over $700,000.00 and with work in process it is expected to run to $1,500,000.00.

By agreement of the parties and with approval of the Court the exhibits attached to the Statement, which had been filed with the Petition in this case, were to be taken as "what they purport to be".

The witness testified that beginning with the purchase of the Mitchell Avenue plant in 1960, and thereafter, he actively sought out other acquisitions and businesses and started in a new venture to produce a machine for office use involving the shredding of paper and spent some $50,000.00 on that venture. To start the business, it required between $200,000.00 and $300,000.00. This venture continued from 1960 through 1962; and because of the lack of patents protecting the business, it was terminated.

The witness testified that he negotiated with U. O. Colson Company; the required purchase price was $1,500,000.00; and after negotiations for some time, these were dropped. These matters were all carried on on behalf of petitioner, Novelart. It acquired an interest in J. J. Hackett Company in Detroit, Michigan.

During the period, Novelart negotiated for the purchase of Manz Corporation in Chicago, Illinois, and Ar-

tistic Card Publishing Company of Elmira, New York. During said period, negotiations were conducted with R. C. Can Company and involved research, development, and production of a plastic lid. This resulted in an unsuccessful operation and was terminated. Petitioner sought to acquire an interest in Crystal Tissue Company in Middletown, Ohio, and had purchased some shares and had made an offer on a substantial number of shares, but one of the insiders in the company had outbid petitioner. Petitioner acquired 10% of the stock of APS, which was a paper specialty company, and, as a result thereof, obtained substantial business for its subsidiaries. Petitioner made an investment of $72,000.00 in Magna and, as a result, received business for its subsidiaries. It acquired the Rapid-American Building, which was occupied by the Rapid Electrotype Company. The building was occupied in part by two other firms engaged in graphic arts, one in rotogravure and another company in an allied business. Petitioner paid $275,000.00 for the building, and after a period of time it was decided to dispose of it rather than put it to use.

The President of petitioner testified that:

> "To have carried out the acquisition of one or two or three, and the one transaction that I have already discussed, and to have gone ahead with the potential and expansion of the corrugated business would have required a total of about 5 million dollars."

Respondent asserted that Petitioner is subject to tax on an unreasonable accumulation of income for the years and in the amounts as follows:

COMPUTATION OF ACCUMULATED TAXABLE INCOME

Year Ended	6-30-61	6-30-62	6-30-63
Corrected Taxable Income	$74,914.41	$313,756.69	$68,357.66
Divs. Rec'd. Credit	15,658.06	16,924.24	8,910.38
Sub-totals (a)	$90,572.47	$330,680.93	$77,268.04
Less:			
Income Tax	$33,054.60	$ 93,790.43	$19,725.80
Excess Contributions	1,969.53	—	981.41
Capital Gains less Attributable tax	1,113.61	177,373.52	18,716.42
Sub-totals (b)	$36,137.74	$271,163.95	$38,973.63
Balance (a) – (b)	$54,434.73	$ 59,516.93	$38,294.41
Less:			
Dividends Paid	15,400.00	15,400.00	15,400.00
Accumulated Taxable Income	$39,034.73	$ 44,116.98	$22,894.41
Tax @ 27½%	$10,734.55	$ 12,132.17	$ 6,295.96

REASONS FOR GRANTING THIS WRIT

I. Petitioner Was an Operating Company and Not a "Mere Holding Company"; and Where Petitioner Spent More Than Its Net Earnings in the Taxable Years for the Purpose of Plant and Equipment, It Did Not Unreasonably Accumulate Earnings.

The evidence in this case, as developed during the trial, clearly established the fact that petitioner was actively engaged in business, in research and development and investment, the search for diversification, and the acquisition of additional plants even though the production was carried on through subsidiaries. This certainly was not a mere holding company. We believe that the business carried on by the petitioner was substantially of the same nature as that of *Crawford County Printing and Publishing Co.* where the Tax Court in 17 T.C. 1404 concluded:

> "HELD: That petitioner did not accumulate its surplus or profits beyond the reasonable needs of its

business and, accordingly, is not liable for additional surtax under section 102, I. R. C."

In the Opinion of the Court at Page 1413, it is stated:

> "There is no contention, and none could fairly be made, that petitioner was organized for the purpose proscribed by section 102, I. R. C. *Nor was petitioner a mere holding company.* It was an operating company actually engaged in the newspaper business."

At Page 1414, the Court stated:

> "Determination of the reasonable needs of its business is, in the first place, a task for the officers and directors of the corporation. What is reasonable in one situation may be unreasonable in a different context of facts. We should be hesitant to attribute a sinister or ulterior motive to the corporation unless such a factual situation clearly appears. The law contemplates that any legitimate business may grow if legitimate means be employed. There are various and sundry ways, all natively legitimate, by which a business may acquire the means of growth and finance its proper expansion. It can issue capital stock or other securities. It may resort to bank loans. Yet again, it may plow its earnings back into the business for immediate uses. *Still another method, equally legitimate, absent an ulterior purpose, is to accumulate its earnings until the expansion can be timely undertaken.*"

We further direct the Court's attention to *Apollo Industries, Inc.* v. *Commissioner,* 358 F.2d 867, where the Court stated:

> "2. In assessing reasonably anticipated business needs to determine liability for accumulated earnings tax, court should keep in mind that such needs vary and are dependent upon nature of business, its credit policies, amounts of inventories and rate of turnover, amount of accounts receivable and collec-

tion rate thereof, availability of credit to business, and similar relevant factors. 26 U.S.C.A. (I.R.C. 1954) §§ 531, 532, 533."

"3. In review of assessment of accumulated earnings tax, neither summary view of balance sheet nor of working capital, nor of amount of net liquid assets can give court sufficient appreciation of real needs of business for funds to assess its reasonably anticipated business needs. 26 U.S.C.A. (I.R.C. 1954) §§ 531, 532, 533."

In the case tried by Judge Atkins, 47 T. C. 75, affirmed, *Rhombar Co.* v. *Commissioner*, 386 F.2d 510, the Court stated:

"4. Failure of Tax Court to consider allegations of taxpayer's statutory statement in support of its claim that it had not accumulated its earnings beyond its reasonable business needs in determining whether taxpayer was a mere holding or investment company within statute making such a fact prima facie evidence of tax avoidance purpose with respect to shareholders was not error where taxpayer never sought to place the statement in evidence or to establish any of the facts contained therein by competent testimony, notwithstanding that Commissioner had made no effort to controvert allegations of statement even though he had been in possession of statement for 18 months before trial. 26 U.S.C.A. (I.R.C. 1954), §§ 533(b), 534, 535(c)(1); Tax Court Rules, rule 31(f), 26 U.S.C.A. (I.R.C. 1954) § 7453."

Attention is called to the record in this case where the Stipulation, in Paragraph 3, admits that a true and accurate copy of petitioner's Statement was attached to respondent's Answer and marked Exhibit D; and in the trial of the case the Court admitted the exhibits attached to the Statement for whatever they purported to set forth, and the testimony of the witness Klein reviewed in detail the activities of the petitioner in its efforts to make

acquisitions as well as the actual investments in customers and the purchase of plants; so that the present case meets the objection set forth in the above cited Decision.

The record further establishes that after the years in question petitioner had actually acquired and was operating the North Vernon, Indiana plant with the expenditure of a substantial amount for the purchase of plant and equipment and the needed operating capital. While objection was made to such testimony, this was overruled by the Court and is in line with the Tax Court's recent Decision in *Faber Cement Block Co.*, 50 T. C. No. 31. In this late case the Tax Court pointed out that the "specific definite, and feasible" requirement of the Regulations does not call for "formal blueprints for action". The test is whether expansion is a real consideration during the years involved. A big factor is whether the taxpayer actually goes ahead with its expansion program. The record in this case clearly establishes the expenditure of some $850,000.00 during the taxable years as well as the expenditure and requirement of a total of a substantially higher amount in the years following the taxable years, but before the trial of this case.

A complete need for diversification, as shown by the testimony presented, should persuade the Court to conclude that the earnings were accumulated for the reasonable needs of the business. Petitioner's research and development of new products for its business as well as the business of its subsidiaries and its active efforts to locate a new business justified large accumulations, even though throughout the period petitioner had not selected a particular business, but considered many alternatives. *Alma Piston Co.*, 22 T. C. M. 948, 1963 P-H T. C. Memo ¶ 63,195.

We respectfully direct the Court's attention to the Decision by the Fifth Circuit in *Mead's Bakery, Inc.* v. *C.I.R.*, 364 F.2d 101:

> "5. Amounts advanced by bakery company to its subsidiary did not represent an unreasonable accumulation of earnings and bakery company, during years in issue, was not availed of for purpose of avoiding income tax with respect to its shareholders, where bakery company's plans for expansion and improvement were not only specific but the company had initiated several of proposed uses of the funds and was in process of further initiating others. 26 U.S.C.A. (I.R.C. 1954) §§ 531-537."

We believe that the Court's statement in *Shaw-Walker Co.* v. *C.I.R.*, 390 F.2d 205, is very applicable to the present case:

> "6. Fact that a taxpayer has financed its growth from retained earnings rather than from sale of additional stock or commercial borrowing should not place it in a position of being subjected to a penalty tax under provision of Internal Revenue Code relating to imposition of accumulated earnings tax. 26 U.S.C.A. (I.R.C. 1954) § 531."

The evidence in this case disclosed that the petitioner had actually spent on the purchase of the Mitchell Avenue plant, the investment in Magna, the investment in APS Company, and the investment in Crystal Tissue a total amount in excess of One Million Dollars; that the acquisition and operation of the North Vernon, Indiana plant involved an investment and capital requirement of One Million Dollars; that the acquisition of the plants looked at and negotiated for by the petitioner would have required an investment of up to Five Million Dollars. These plants or any part of them would have required all of the monies accumulated by petitioner in over fifty

years. The total cash, accounts receivable, and inventories during the taxable years, available to the petitioner, would have been insufficient to meet its program of diversification and expansion.

During the taxable year ended June 30, 1961, its current assets were reduced by some $650,000.00. By the end of the taxable year June 30, 1963, the current assets had been decreased by $850,000.00. The actual earnings of the corporation available for distribution during this three year period was $103,000.00; and if credit is given for the insurance premium paid on its key men, the available funds in the total of the three taxable years would have been approximately $37,000.00, hardly a good example of unreasonable accumulations of earnings.

We direct your attention to the following cases:

Electric Regulator Corporation v. *C.I.R.*, 336 F.2d 339:

> "1. Use to which a corporate taxpayer put its previously accumulated earnings, as well as its anticipated needs, is an essential consideration in determining whether, for undistributed earnings tax purposes, earnings and profits have been accumulated beyond reasonable needs of the corporation. 26 U.S. C.A. (I.R.C. 1954) § 537."

Mohawk Paper Mills, Inc. v. *U. S.*, 18 AFTR2d 6111:

> "Accumulated earnings tax not imposed: corporation made reasonable accumulations for needs of its business. Corporation contemplated building a new paper machine. Corporation needn't have borrowed. Accumulations weren't motivated by tax avoidance. Reference: 1966 P-H Fed. ¶ 4056."

In the above-quoted *Electric Regulator Corporation* case, at Pages 345 and 346 the Court stated:

> "Courts * * * must not blind themselves to the realities in this age of rapid technological change.

> The product of today is frequently outmoded tomorrow. * * * Nor is it always possible for a company in advance to set aside a specific sum to achieve a specific goal. Comments made in the past to the effect that a definite plan actually followed through must be on the company's books and records before moneys assigned thereto become anticipated needs may have to be appropriately qualified in particular cases.
>
> "I the Tax Court's views here were to be accepted, they would give to the Treasury virtually absolute power to stifle or encourage economic growth as it—not the corporate directors—decided how each company should handle its corporate and financial affairs * * *."

The Supreme Court has put to rest any question as to "the purpose" necessary to make § 531 applicable. *United States* v. *Donruss Co.*, 393 U.S. 297 (1969). In *Donruss*, the trial court instructed that, in § 531 cases, tax avoidance had to be "the purpose" of the accumulations. Reversing the trial judge, the Sixth Circuit held the tax applied if tax avoidance was the "dominant, controlling or impelling motive" for the accumulation. The Supreme Court, in a 6-3 decision, disagreed with both the trial and appellate courts. Accordingly, pursuant to *Donruss*, the taxpayer, having failed tc prove the reasonable business needs for the accumulation, must establish that tax avoidance was not "one of the purposes" for the accumulation of earnings.

In *C.I.R.* v. *The Shaw-Walker Co.*, 393 U.S. 478 (1969), the Supreme Court vacated judgment and remanded the Sixth Circuit's decision *per curiam* for reconsideration in the light of the *Donruss* decision. In *Battlestein Investment Co.* v. *United States*, 69-1 USTC ¶ 9219, 23 AFTR 2d 69-784 (S.D. Tex. 1969), the *Donruss* "purpose" test was cited. The court emphasized loans to shareholders, investments in unrelated assets and the declaration of dividends for the sole purpose of avoiding personal holding company

treatment under the 1964 revision to conclude that avoidance of the stockholders' tax was one of the purposes for the accumulation.

Calling attention to § 537's provision that "the term 'reasonable needs of the business' includes the reasonably anticipated needs of the business," the Tax Court in *Adolph Coors Co.*, T. C. Memo 1968-256, found no unreasonable accumulation of earnings where they were retained: (1) to assure completion of projects begun during the taxable years; (2) to protect against anticipated increases in inventories packaging and other increased production and administration costs; (3) to self-insure against a fourteen million dollar damage suit; (4) *to fund experiments in new modes of manufacturing.*

The Tax Court in *Faber Cement Block Co.*, 50 T. C. 31 (1968), *acq.* 1968-43 I.R.B. 6, has expanded on its opinions in *Nemours Corporation*, 38 T. C. 585 (1962) *aff'd per curiam* 325 F.2d 559 (3rd Cir. 1963) and *Whitney Chain & Mfg. Co.*, 3 T. C. 1109 (1944), *aff'd per curiam* 149 F.2d 936 (2nd Cir. 1945). In *Faber Cement* the Commissioner argued that, without disturbing liquid assets, a corporation has other assets for utilization as dividends in kind; therefore, the corporation, having failed to so distribute in kind, had unreasonably accumulated earnings. Labelling the Commissioner's view distorted, the Tax Court noted that, in *Nemours* and *Whitney Chain & Mfg. Co.*, it first determined that the accumulated earnings were not needed for the reasonable needs of the business and *then* searched for potential sources of dividends. *Faber Cement* also demonstrates that ultimate fruition of corporate plans, even though in years not before the Court, greatly assists the taxpayer. *Cf. Dixie Inc.* v. *C.I.R.*, 277 F.2d 526 (2nd Cir. 1960).

Giving weight to a variety of elements, the Sixth Circuit reversed the unreasonable accumulation holding in

The Dahlem Foundation, Inc. v. *United States,* 69-1 USTC ¶ 9129, 22 AFTR2d 5962 (6th Cir. 1968). The court noted that, if all the earnings and profits had been paid out, the corporation would have possessed inadequate reserves to purchase land it planned to acquire and to meet contingencies. The court was not disturbed because one of the major land purchases took place in a subsequent tax year.

II. (A) Earnings of Petitioner Were Determined to Be Necessary for Financing Its Established Plans for Expansion.

What we have said above applies with equal force under this subheading. The point that we wish to stress is that the earnings of the petitioner, subject to unreasonable accumulation, are the earnings of the taxable years involved, and not the accumulation over a period of some fifty years before. It certainly is clear and obvious that the earnings during the years in question, amounting to either a little over $100,000.00 or, if the insurance premium is deducted, to a little over $35,000.00, was hardly sufficient to meet any one of the expenditures made during the taxable years.

Certainly, *the law does not undertake to penalize undistributed earnings, except such as are earned during the taxable years under consideration.* The law clearly does not authorize the Commissioner or permit the Courts to impose a penalty tax measured against all undistributed earnings in the years in question simply because there had been earnings accumulated in prior years. This is not to say that the prior years' earnings may or may not be given consideration in helping the Court determine whether the current years' earnings have been reasonably accumulated. However, it would be unreasonable to require that a taxpayer first distribute *all* of its accumulations before it can retain a penny of the current years' earnings.

Petitioner's plans for expansion were evidenced by the Minutes of the corporation, which were offered during the trial and had been submitted with petitioner's Statement which was attached as an exhibit to respondent's Answer. Whether such plans were at great length or absolutely specific on the subject is not required in a case where a corporation has only one stockholder as is the stipulated facts in this case. We think that this Court should consider in connection therewith the language of the Court in a recent case.

> "We realize that petitioner's directors act in a rather informal manner and that their plans for expansion might not be as specific as desired nor are all their plans reduced to writing and contained in formal minutes. However, the history of petitioner has been to act in an informal manner. The executive committee, which is the core of the petitioner's management, meets daily and when necessary can act with deliberate speed. A closely held corporation cannot be held to the same strict formalities of large public corporations. * * * *Duke Laboratories, Inc.* v. *United States* * * * 337 F.2d 280 (C.A. 2, 1964). We have found as a fact that petitioner did not have any formal plans for expansion after 1958. However, by this finding we do not mean that petitioner would not be justified in retaining part of its earnings for future expansion. Nor do we mean by this finding that petitioner did not have any plans for expansion subsequent to 1958. As stated earlier, petitioner's entire history reflects a policy of constant growth. It is not always possible for a company in advance to set aside a specific sum to achieve a specific goal." *John P. Scripps Newspapers,* 44 T.C. at 469.

This is simply a more generalized statement of the things which the Second Circuit said about the funding of new product development in *Electric Regulator Corporation* v. *Commissioner,* 336 F.2d 339 (2d Cir. 1964).

Both the Second Circuit and the Tax Court in other recent cases have construed the Statute and Regulations in the same way the Tax Court did in the *Scripps* case. *Duke Laboratories, Inc.* v. *United States,* 337 F.2d 280 (2d Cir. 1964); *Ted Bates & Co.,* 24 CCH TCM 1346 (1965).

(B) Interest Should Not Have Been Imposed.

It should be noted that this Court in *United States* v. *Donruss,* supra, observed that the accumulated earnings tax was intended by Congress to be a penalty and *not* a tax. See also, *Montgomery Co.,* 54 T.C. 986, at 1010. § 6601 of the Internal Revenue Code clearly establishes that interest is allowed and computed on tax. However, Paragraph (f)(3) of § 6601 establishes with equal clarity that no interest is to be imposed in respect of any penalty until ten days from the date of notice and demand therefor.

The exact question was before the Court of Claims in *Motor Fuel Carriers, Inc.* v. *U. S.,* 420 F.2d 702 (1970), in a suit to recover the amount paid as interest upon accumulated earnings tax. The court, in an opinion by Judge Davis, held that it was unnecessary to find that the accumulated earnings tax was a "penalty", since in its view it was an "additional amount" or "addition to the tax" within the meaning of Section 6601.

In an extremely perceptive analysis of the legislative history of the accumulated earnings tax and of the interest section, Judge Davis concluded that the intention of Congress was clear that, for the purposes of the imposition of interest, Section 531 imposes an "addition to the tax" upon which interest begins to run only after demand. He stated at page 705 of the Opinion:

> ". . . that the tax is not 'self-assessing' but is levied only after and by determination of the Revenue Service. There is no provision in, or part of, Treasury

Form 1120 (the return form) for reporting the amount subject to this tax; nor are there any schedules or instructions for reporting the item. It is left wholly to the Government's initiative. See Mertens, Law of Federal Income Taxation, Volume 7, Section 39.57 (Revised Edition 1967).

"This procedure has not come about by happenstance, the Treasury's neglect or the irresponsibility of corporate taxpayers. It is inherent in the nature of the tax—and was formerly recognized specifically by Congress—that a taxpayer can hardly determine for itself, with any accuracy, if the tax is due, and if so, to what extent."

(C) The Statute of Limitations.

§ 6501 of the Internal Revenue Code bars the imposition of an assessment after the lapse of three years. The net effect of the Decision of the lower Courts in this case is to permit the imposition of a tax on earnings accumulated for years prior to July 1, 1960, being years against which the Statute of Limitations had run. As we have pointed out, it was in the prior years in which Petitioner had accumulated the earnings upon which the assessment was based in the years in question. This may best be illustrated by noting the decline in cash and liquid assets during the fiscal year 1961:

Cash as 7/1/60	$1,558,234.34	
Governments and stocks, etc.	1,478,139.85	$3,036,374.19
Cash at 6/30/61	$1,948,241.20	
Stocks, etc. (no governments)	682,356.75	2,630,597.95
Decline in such liquid assets		$ 405,776.24

Petitioner was entitled to a credit equal in amount to the earnings and profits for prior years which had been

retained for the reasonable needs of the business, which credit was in the full amount of the retained earnings for such prior years. It is obvious, therefore, that the accumulated taxable income for the years in question, subject to the imposition of the § 531 tax, amounted to zero.

III. The Amount Expended for the Premium Paid for Life Insurance on Key Employees Should Be Deducted from Net Earnings Before Considering Earnings Available for Distribution.

The Tax Court decided in *General Smelting Co.*, 4 T. C. 313, at Page 324, as follows:

> "The payments of the premiums on these policies in the years 1939 and 1940 and the payments of the loans and interest which stood against them increased the cash surrender value thereof, stopped the 6 percent interest running against the loans to the extent they were paid, and increased petitioner's equity in the policies.
>
> "Under the circumstances which we have just narrated, we think that petitioner's expenditures in connection with these policies in 1939 and 1940 were related to its business, to wit, the preservation and conservation of its funds, and not a mere investment of its funds in an outside venture or an investment unrelated to its business. On issue 2 we sustain petitioner."

In the case of *Emeloid Co.* v. *Commissioner of Internal Revenue*, 189 F.2d 230, the Court stated at Page 233, as follows:

> "What corporate purpose could be considered more essential than key man insurance? The business that insures its buildings and machinery and automobiles from every possible hazard can hardly be expected to exercise less care in protecting itself against the loss of two of its most vital assets—managerial skill and

experience. In fact, the government has not seriously contended here that key man insurance is not a proper corporate purpose."

The difficulty in this case arises from the fact that the respondent seems to rely entirely on Section 533(b) which states:

> "The fact that any corporation is *a mere holding or investment company* shall be prima facie evidence of the purpose to avoid the income tax with respect to shareholders."

Our first question then is: What is meant by the language, "a mere holding or investment company"? It certainly does not mean a "personal holding company" because such a company is excluded or exempted or excepted from the accumulated earnings tax under Section 532(1). The word "*mere*" in its common, ordinary acceptance is certainly well defined by Webster's Dictionary, and Congress should be taken to have meant its ordinary meaning. Webster defines "mere":

> "Nothing less than—absolute, sheer, unqualified—only this and nothing else, nothing more than."

In line with such definition, how can respondent argue that since petitioner, in addition to investment, engaged in research and development, that it was a mere investment or holding company? The Tax Court did not decide this issue.

In Prentice-Hall, Paragraph 21,332, it is set forth:

> "*The tax is imposed only on excessive accumulations in the current year.* Excessive accumulations in prior years are not taxed in the current year, although prior accumulations may be a factor in deciding if the current accumulation is excessive."

Under the provisions of law, you not only exempt from the imposition of tax accumulations in prior years, but you also exclude from consideration various items listed in the act, particularly capital gains, dividends paid, and distributions made.

The respondent makes no claim of any tax due for the approximately Five Million Dollars of earnings accumulated prior to July 1, 1960, nor does he take into consideration the dividends and distributions made prior to that date nor in the three succeeding taxable years, but disregards the fact that there had been a distribution of premiums paid on policies of insurance owned by the corporation-taxpayer during the three taxable years.

No issue was made of this matter by the assessment for the taxable years in question nor for more than ten years previously. The company purchased policies of life insurance on its key personnel and paid the premium in each of the years. The premium was not deductible. ¶ 16,751, Prentice-Hall, states:

> "Basic Rules—In general, deduction is not allowed for the payment of life insurance premiums. Correspondingly, with certain exceptions, the proceeds of a life insurance policy paid by reason of the death of the insured are exempt from income tax. See ¶ 8,111, et seq."

The above paragraph merely paraphrases the language of Section 264 of the Internal Revenue Code, which states that no deduction shall be allowed for premium paid on a life insurance policy covering the life of any officer or employee * * *. There is no question in this record but that the policies were purchased and are owned by the petitioner. Here, we direct the Court's attention to Exhibits 1, 2 and 3, the Tax Returns of the Petitioner for the taxable years, where the cash value of the life insurance is

carried in Schedule L, Line 12. You will notice that as of the end of the taxable year the cash surrender value of the insurance was $252,566.58; and this Court will certainly know it to be a fact, a fact of which judicial knowledge may be taken, that with the payment of premiums of an average of $22,000.00 a year that it would take ten or more years to build a cash surrender value of the amount above-mentioned.

We do not believe the Court will pay much attention to respondent's argument that because Mr. Klein owns 100% of the stock of the petitioner, and that because of such control he might, at some future date, cause a change to be made by the petitioner of the designated beneficiaries or, perhaps, dispose of its ownership that, for that reason, the payment of premium by the petitioner should not be considered as a distribution rather than an accumulation of income. The fact is, and respondent's counsel and the Court know, that if Mr. Klein caused a distribution to be made, which he has a perfect right to do, he would pay tax on the amount distributed.

When we look to Exhibit 7 attached to the Stipulation, we find that the key personnel of petitioner covered under these policies of insurance are A. C. Sides, H. J. Bruder, Charles H. Klein, Lucien Lazarus, Herb Fritz, and Marvin H. Schwartz. No question was raised by the respondent that these people are not key personnel of the petitioner, nor that the insurance carried on their lives was improper, nor that the payment of premium on the policies insuring the lives of any of them, or primarily Charles H. Klein, constituted a distribution to any of the persons.

In ¶ 16,765, Prentice-Hall, the rule is stated:

> "Premiums paid by an employer on life insurance covering the life of an officer or employee are not de-

ductible *if the employer is a direct or indirect beneficiary under the policy.*

"If an employer insures the life of an officer or employee and is not a direct or indirect beneficiary under the policy, the premiums paid by the employer are deductible as additional compensation, provided the total compensation so paid is reasonable for the personal services that are actually rendered. Such deduction will not be disallowed merely because the employer derives a benefit from the increased efficiency of the officer or employee.'

The Tax Court has affirmed the holding that a deduction is allowed to the corporation for insurance premiums paid on the lives of officers where the corporation was not the beneficiary, and the total compensation was found to be reasonable. *Brown Agency, Inc.*, 21 BTA 1111; *Berizzi Brothers Co.*, 16 BTA 1307; *Peerless Pacific Co.*, 10 BTA 103.

The Court has sustained the Commissioner in disallowing deduction for payments by an employer-corporation on insurance on officers or employees (usually the principal officers and stockholders) where the employer is directly or indirectly a beneficiary. *Peerless Patterns Co.*, 29 BTA 690; *Chism Ice Cream Co.*, 322 F.2d 956; *Wilcox Investment Co.*, 3 T. C. 458.

It must be obvious that the premium on the life insurance was proper; *was paid out; was no longer available for distribution;* did not constitute an accumulation; and should have been considered in determining the remaining earnings during the taxable years available for distribution.

The Sixth Circuit stated:

"The short answer to the contention that a deduction should be allowed for life insurance premiums is that 26 U.S.C. § 535(b) provides for specific adjust-

ments in computing the accumulated taxable income. That section does not authorize an adjustment in the form of a deduction for life insurance premiums."

That Court as well as the Tax Court is confusing the language of § 535(b) relating to adjustments with the provisions of § 535(c), which permits the application of earnings for the reasonable needs of the business. Money expended by the taxpayer for plants as an investment was properly permitted to be credited as an expenditure for the reasonable needs of the business. The Tax Court found that at June 30, 1961, there was a reasonably anticipated need of the business of $250,000.00. This was also the situation at June 30, 1962. The Court said:

> "The only reasonable needs including anticipated needs, shown as of that time amounted to $782,000. The same is true with respect to the taxable years ended June 30, 1962 and June 30, 1963."

Having in mind that the insurance on the key employees had existed from 1940, for a total of about 22 years, it is hardly right to come in at this late hour and say that such premium was not a reasonable need of the business.

IV. The Constitutional Question.

This case, for the first time, presents the question whether a corporation that over a period of sixty years had accumulated earnings is to be treated differently than a corporation that had no accumulations over the $100,000.00 credit provided by Section 531 of the Internal Revenue Code. To put it differently and having in mind that Federal taxes are based on an annual basis, can a corporation be held to have unreasonably accumulated any part of its current earnings because it had a large surplus accumulated in prior years? The Tax Court stated:

> "Here, the petitioner, as of the beginning of the taxable year ended June 30, 1961, had accumulated

earnings and profits from prior years in the amount of $4,772,080.74, of which $1,558,234.34 was represented by cash, and $1,478,139.85 was represented by investments in Government obligations and stocks, bonds and other securities. *It is against this background that we must consider whether the earnings and profits of the taxable year in question were permitted to accumulate beyond the reasonable needs of the business.*"

"* * *, in September, 1962, such plant was purchased by petitioner for $532,000.00. Under these circumstances, we think it reasonable to conclude that as of the end of the taxable year ended June 30, 1961, one of the reasonably anticipated needs of the business was additional plant space to cost approximately $532,000.00. This was also the situation at the end of the taxable year ended June 30, 1962."

In the present case the Commissioner determined accumulated taxable income for the years ended June 30, 1961, in the amount of $39,034.73, out of which amount the taxpayer had paid premiums on a group life policy on its officers in the amount of $24,857.05, and in the year ended June 30, 1962, the amount of $44,116.98, out of which the taxpayer had paid a premium in the amount of $22,212.35, and in the year ended June 30, 1963, income of $22,444.41 and premium paid in the amount of $21,495.40. Thus, the total income subject to accumulated earnings tax for the three year period was $106,000.00, and, during that three year period, it paid out premium on insurance the amount of $68,000.00.

Assuming, *arguendo,* that the payment of premium on life insurance, although a necessary expense, was not to be deducted from the accumulated earnings tax income during the three year period of $106,000.00, as against this amount the Tax Court found that the reasonable needs of the business during the three taxable years involved here-

in was the aforementioned amount of $532,000.00, and the Tax Court further finding that "there was a reasonably anticipated need of the business of petitioner of about $250,000.00 for this purpose".

The Tax Court having found a reasonable need for business of a total of $782,000.00, certainly the $106,000.00 was not sufficient to meet such needs.

We are then faced with this question: If a corporation has an accumulated surplus at the beginning of the year of $882,000.00, that is the specific exemption of $100,000.00 and the reasonable needs of $782,000.00, it would be taxed on the $106,000.00 of undistributed earnings during the three year period. If, on the other hand, the corporation has a surplus of, let us say, $650,000.00, the tax would not be applicable. Under such a situation where the existence or non-existence of this tax is based on what a corporation has accumulated in prior years, such a law cannot apply equally to all corporations, and it would seem to be in violation of the United States Constitution.

The Sixteenth Amendment to the United States Constitution provides:

> "The Congress shall have power to lay and collect taxes on *incomes*, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration."

In *Helvering* v. *Northwest Steel Rolling Mills*, 311 U.S. 46, the Supreme Court held that the fact that surtax under Revenue Act 1936, §§14, 26(c) (1), was imposed upon annual income only, if not distributed, did not make it anything other than a true tax on "income" rather than "capital" within the meaning of this amendment, irrespective of whether there might be an impairment of the capital

stock. The reasoning behind the Court's Opinion was that the tax was on undistributed income in its true sense and did not violate the Sixteenth Amendment to the Constitution. In the present case, the tax would not apply in that in the three year period the total income subject to tax was $106,000.00, and the reasonable needs during that period was $782,000.00, but the Tax Court held that the tax applies because the capital accumulated by the taxpayer in more than half a century before the tax year was sufficient to meet the $782,000.00, and, for that reason, it should have distributed the $106,000.00. This cleary is a tax reasoned and based on the prior accumulations, which constituted in law capital, rather than a tax on the income of the current tax years.

The Tax Court cites as authority for its position its earlier decision in *John P. Scripps Newspapers*, 44 T. C. 453, and *Smoot Sand & Gravel Corporation* v. *Commissioner*, 274 F.2d 495. A careful reading of the Opinions in those two cases clearly distinguishes them from the present case. This case clearly presents for the first time the question whether it was the intention of Congress, and within its power, to lay a different tax on corporations that were richer than others. It measured the difference by wealth or capital, and in doing so, we contend, it ran afoul of the Sixteenth Amendment to the United States Constitution. We contend that such a tax would also do violence to the provisions of the Fifth Amendment of the United States Constitution, which requires equal treatment and without discrimination among taxpayers.

The Supreme Court in considering the earlier accumulated earnings case, *Helvering* v. *National Grocery Co.*, 304 U.S. 284, sustained the constitutionality of the law insofar as it permitted the imposition of a penalty tax on the corporation formed or availed of for the purpose of avoid-

ing tax on its shareholder. Here, we are faced with the question whether or not a law which measures the tax or penalty by the wealth of the taxpayer can be sustained.

The United States Supreme Court in the case of *Healy and Smith v. Commissioner,* 345 U.S. 278, taught us the lesson that:

> "Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the accounting must be done over again to reflect events occurring after the year for which the account is made and would violate the spirit of the annual accounting system. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed."

The taxpayer in this case, over a period antedating the effective date of the income tax law, during years when income tax rates ranged in the 1% to 4% bracket, was able to build up a substantial business and accumulate a substantial surplus. Whether this surplus was made up of earnings, which are subject to the accumulated earnings tax, or were made up of capital gains or contributions to capital, which are not subject to tax, was not and could not be an issue in the trial of this case; yet, the Tax Court merely looks at the "wealth" of the petitioner and states that because it has total assets of 5 million dollars, and because half of that, or 2-1/2 million dollars, is in cash and securities, it is subject to the penalty even though its earnings during the taxable years were about $100,000.00, and its expenditures were about $800,000.00, and its current assets at the beginning of the tax period involved herein were $2,657,551.54 and at the end of the taxable years were $1,805,222.20 or clearly a reduction of about $850,000.00.

Petitioner's current assets as of June 30, 1960, June 30, 1961, June 30, 1962, and June 30, 1963, were as follows:

	6-30-60	6-30-61	6-30-62	6-30-63
Cash	$1,558,234.34	$1,948,241.20	$2,112,230.50	$1,768,253.27
Gov't Obligations	995,399.82	–0–	–0–	–0–
Notes and accounts receivable	103,917.38	47,071.98	98,308.36	26,625.52
Inventories	–0–	12,101.83	10,668.41	10,343.41
Total:	$2,657,551.54	$2,007,415.01	$2,221,207.27	$1,805,222.20

The Tax Court could not see how the payment of premiums on group policies could be given consideration in view of the fact that Congress did not make such premiums deductible. This is a tax based on accumulation, and no accumulation exists where there is a distribution of part of the earnings for insurance purposes. Just the same as where there is an investment of part of the earnings in plant equipment and machinery, such investment is not a deduction, but is given consideration in determining accumulated earnings tax.

This is not a case where the taxpayer failed to pay dividends because the record clearly established the following:

In each of the years involved substantial dividends were paid out of the taxpayer's current earnings after taxes, as the following information clearly reflects:

Year	Earnings after Taxes for Dividends	Dividends Paid	Percentage of Earnings Paid in Dividends
F/Y 1961	$49,434.73	$15,400.00	31.22%
F/Y 1962	$59,406.10	$15,400.00	25.9%
F/Y 1963	$37,372.71	$15,400.00	41.2%

It is interesting to note that during the presentation of this case to the Court below Counsel for Respondent was asked by the Court that if capital gains were not subject to the tax imposed by § 531, when did the change occur, subjecting them to tax. Counsel's answer was that the change occurred after the capital gains became part of surplus. There is no statutory authority for, nor do the Decisions support, this statement. Since § 535(b)(6) specifically exempts from the tax long-term capital gains in the year of receipt, it would seem anomalous to determine that such gains lose their exempt status in years subsequent to their receipt.

CONCLUSION

For the foregoing reasons this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

STANLEY GOODMAN
GOODMAN & GOODMAN
1016 Fourth & Walnut Building
Cincinnati, Ohio 45202
Counsel for Petitioner

SOLICITOR GENERAL OF THE
UNITED STATES
Department of Justice
Washington, D. C. 20530
JOHNNIE M. WALTERS
Assistant Attorney General
Tax Division
Department of Justice
Washington, D. C. 20530
K. MARTIN WORTHY
Chief Counsel, I. R. S.
Washington, D. C. 20224
Counsel of Record